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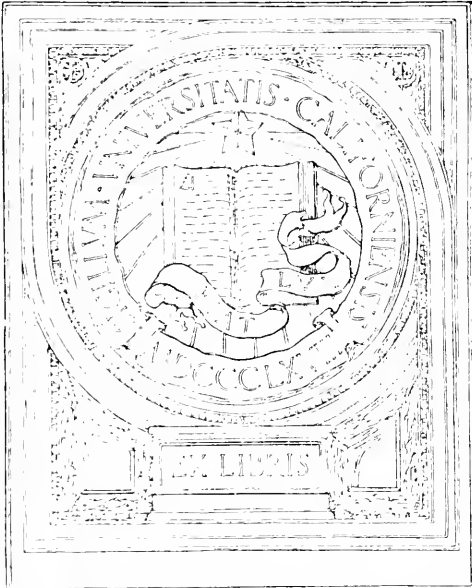


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by

Hermann. F. Arens

UNIVERSITY OF CALIFORNIA
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Industrial Securities

By

HERMANN F. ARENS, PH.D.

Professor of Business Economics, Northeastern College.
Economics Expert, Babson Statistical Organization, 1916-19.
Professor of Economics, Babson Institute, 1919-20.



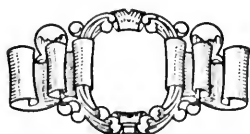
AMERICAN INSTITUTE OF FINANCE

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AMERICAN INSTITUTE OF FINANCE
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OUR
"COMPLETE EDUCATIONAL COURSE"
IN THE SCIENCE OF
MAKING MONEY MAKE MORE MONEY

This list is arranged in the order of proper reading. The books are accompanied by a series of test questions, key problems and analyses outlines, enabling the student to apply the knowledge acquired to immediate stock market and investment conditions.

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| 1. <i>Developing Financial Skill</i> | 11. <i>Investment Securities</i> |
| 2. <i>Forces Which Make Prices</i> | 12. <i>Business Cycles</i> |
| 3. <i>Manipulation and Market Leadership</i> | 13. <i>Measuring and Forecasting General Business Conditions</i> |
| 4. <i>Handling a Brokerage Account</i> | 14. <i>The Technical Position of the Market</i> |
| 5. <i>Market Information</i> | 15. <i>Money and Credit</i> |
| 6. <i>The Essential Features of Securities</i> | 16. <i>Business Profits</i> |
| 7. <i>The Value of a Railroad Security</i> | 17. <i>Launching a New Enterprise</i> |
| 8. <i>Industrial Securities</i> | 18. <i>Securing Capital for Established Enterprise</i> |
| 9. <i>Oil Securities</i> | 19. <i>Internal Financial Management</i> |
| 10. <i>Mining Securities</i> | 20. <i>Search for Bargains</i> |

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CHAPTER I

OUR INDUSTRIAL DEVELOPMENT

Industrial Conditions Three Centuries Ago

Three hundred years ago, the economic and industrial life of the people of Western Europe presented little variation as between one country and another, or as between different sections of the same country. The great bulk of the population was employed on the land extracting from the soil grain, vegetables and flax; herding the sheep and cattle, tending the hogs and hens; mining from the earth the basic necessities of human life.

In each village the blacksmith furnished what iron work was needed. He made weapons, and wheel rims, and shod horses. He also made nails, bolts and hinges, all by hand. The mason and the carpenter performed their constructive functions as today. The shoemaker made shoes as well as repairing them.

As would be expected under such circumstances, living was simple and meagre. No large populations could exist, because such a simple economic organization could not furnish the means of feeding, clothing and sheltering many people on the limited supply of land which Western Europe provides.

What a picture! What a contrast with the economic organization of today!

The Industrial Revolution

The change from the simple economic organization of the sixteenth century to the complicated and sensitive organization of today is known as the Industrial Revolution. It comprises the growth of large-scale industry, the factory system, the development of banking and transportation; the revolution in agricultural and mining methods; the discovery and exploitation of coal, oil, the steam engine and electricity, and more recently the internal combustion engine and the mastery of the air.

With all this has come the development and extension of industrial organization and corresponding expansion and diversification of the security markets in which industrial securities have within the last few years attained such prominence.

What Caused the "Industrial Revolution?"

The usual answer is the invention of the steam engine, or the invention of the factory system. Another favorite answer is the improvement in transportation both on land and sea. These do not answer the question as to time. Why did the Industrial Revolution start when it did instead of two centuries earlier—or, perhaps, two centuries later?

The answers given above, moreover, fail to explain the cause as well as the time. That the multitude of inventions and improvements in technical processes and economic organizations should have been born in the last two centuries is certainly marvelous and must have had a powerful cause. It cannot be that human intellect is vastly superior now to what it was some years ago, or that before 1750, or thereabouts, men were slow of mind and stupid. To attribute the beginning of this great movement to accident is merely to give up the attempt to explain.

Growth of Markets

The true explanation is found in the enlargement of markets. The discovery of America was followed in the sixteenth, and especially in the seventeenth, century by the exploitation of the mines of Peru and Mexico, and millions upon millions in silver and gold came to Spain, robbed from the natives of America. Portugal also took a share and the way was opened by sea to the markets of India and the Far East. The possessors of the treasure from America hastened to spend the money for goods of all sorts, while trade with the Far East brought new wealth to Holland, Britain, and Portugal.

The initial force that started the great Industrial Revolution is thus seen to have been a new and powerful demand for goods. In response to this demand came the invention of the mariner's

compass, improvements in shipbuilding and sailing to give greater safety, greater cargo space, and greater speed. On land, the factory system was invented to give greater production, to supply the new markets which now offered profitable prices: machines to increase the productivity of human labor, power to drive the machines, good roads, canals and railroads to answer the demand for cheap and safe transportation. All these inventions and improvements in the technical processes of production came in answer to the incessant demand for more goods offering the lure of more profit.

The Revolution started in Britain because there the measure of industrial freedom was greatest, and Britain shared but little in the gold and silver from America. The Spaniards who brought the gold were content to buy what they wanted and cultivate a life of genteel indolence, but Britain bought her share by industry.

The process once started was cumulative and as new inventions were made and new lands opened, opportunities increased and living conditions improved, making new demands for the products of industry. Wherever the freedom of business enterprise extended, a new class of "business men" or business enterprisers became the keystone of the economic arch.

Corporate Organization Appears

Until the middle of the 19th century practically all the manufacturing or merchandising enterprises were managed by individual enterprisers or as partnerships. Family enterprises were the most common. Two or three brothers or a father and his sons undertook business together. The corporate form of organization was reserved for undertakings so great that no small group of private enterprisers could be found willing or able to supply all the capital needed or to take all the business risk. Such, for example, were the great trading and colonizing companies, the Dutch East India Company, and the British East India Company.

The corporate form of organization was really brought to the fore by the introduction of the steam railroad. Railroad enterprise required large amounts of capital and in their early days

were considered too risky an enterprise to justify the partners, even of a wealthy business partnership, in risking their all on such a new thing.

This brought a large amount of railroad securities into existence. They became the most attractive medium of speculation. Before their appearance, the usual medium of speculation had been the bonds, consols or rentes of the various national governments and the shares in the great trading companies.

From 1830 to 1890, the great railroad systems throughout the world were being built. The securities of cities, states and empires simultaneously retired from the center of the speculative stage. They moved into the investment class.

Industrial Corporations to the Fore

Meanwhile great industrial enterprises were growing up. At first partnerships were turned into corporations purely for convenience and in order to escape the burden of unlimited liability. If a partner dies, the firm ceases to exist and must be liquidated or another partner must be found to take over the interest. The death of a stockholder in a corporation has no immediate effect on the business. A corporation is a legal personality and goes right on. While perceiving the advantages of the corporate form and in many cases changing to that form, most industrial enterprises remained close corporations, family affairs, just as before incorporation.

It is only with the coming in of large-scale industry dominated by the economic law of "increasing returns" that the stock became distributed beyond a limited circle and was "listed" and traded in on the exchanges. The movement toward expansion and the integration of smaller units into the large-scale industrial corporations began in the late '70's.

Motives for Consolidation

There were two motives drawing the small- and medium-scale industrial establishments toward consolidation. One was the well-known economics of large-scale production. When several

manufacturing plants unite under one management a number of economies are often possible. Chief among these are the following:

1. The possibility of purchasing in larger quantities at lower cost.
2. A wide market, hence less fluctuation in demand for products.
3. The elimination of poorly situated plants in favor of the more favorably situated.
4. The possibility of securing highest grade of men in all departments and using each high-grade man to his full capacity in the work he does best.
5. Utilization of by-products that would not pay on a small scale.
6. Elimination of cross shipments.
7. A large corporation because of its prominence and large resources and greater stability has a great advantage in financing over the small and local corporation.

But the possible economies of large-scale production did not constitute the only or perhaps the chief motive. More prominent in the minds of those who brought about these combinations was the lure of getting rid of competition and securing something approaching a monopoly.

Development of Combinations

The first form which these combinations took was that of a holding trust under which all the stockholders of the various companies deposited their stock with a board of trustees who operated all the plants in the interests of the common pool. Hostility to these "trusts" ultimately forced their dissolution.

Then followed the organization of holding companies. Until 1871 the weight of court authority both in Great Britain and the United States was against the power of one corporation to become a shareholder in another unless such power was expressly conferred by law. In 1869, New Jersey passed the famous constitutional amendment permitting such a step.

Two well-known examples will serve to illustrate the progress in the formation of the great industrial combines. The Standard Oil Trust was formed in 1879. In 1892, this trust was superseded by a holding company, the Standard Oil Co., of New Jersey, with a capital of ten million. In 1899, this company increased its capital from ten million to one hundred and ten million, treating the original ten million outstanding as preferred stock.

The U. S. Steel Corporation was formed in 1901 from the Carnegie Steel Co., the National Steel, Illinois Steel, American Steel Hoop, American Wire and Steel, National Tube and others. From 1901 the consolidation movement progressed rapidly and drew hostile public attention which resulted in the enactment of the Sherman Anti-Trust Law and Federal prosecutions. In spite of public hostility the formation of giant corporations went on and one field of industry after another has been invaded.

Speculation in Industrials

Up to 1910, the overwhelming volume of speculation was in railroad stocks, and railroad bonds were the most prominent investment securities. By 1910, the "industrials," led by U. S. Steel, were coming to the front and attracting public attention. The Interstate Commerce Commission and the Railroad Commissions of the several States were drawing the net tight around the operations of all railroad systems. This came at a time when, from economic reasons, the operation of the railroads was becoming difficult.

Industrial corporations were not subject to these limitations. Inside information for those "in the know" offered a splendid opportunity for profit. Then came the war boom. Prices rose rapidly, demand proved insatiable and there was little government control over prices. The railroads, on the other hand, could not raise their rates without permission of government authorities and they faced increasing costs of operation through the rise in costs of material and labor. The spectacular rise in Bethlehem Steel from 40 to 800 focussed public attention and attracted the speculative fraternity.

Increasing Publicity for Industrial Companies

But, with this development among the industrials, the demand for publicity in regard to financial conditions and earnings has become strong. Practically all industrial corporations whose stock is listed on the exchanges now furnish detailed financial statements at least yearly, and many issue such statements quarterly. Even with these statements, however, keen discrimination is still necessary because financial statements are by no means proof against juggling. When a large corporation presents a statement involving the financial accounts of numerous subsidiaries, it is difficult even for an accountant to get beneath the surface. There are innumerable ways in which assets can be concealed or inflated as desired, and it is obviously impossible for the average investor or speculator to get much more real information than the management wishes to give out.

The internal revenue laws have done wonders in improving and standardizing corporation accounting. By forcing every corporation to render an annual account, following certain principles, the statements of corporations, both large and small, have been rendered more uniform and reliable, and publicity encouraged. By allowing a firm to earn 8% profit on "invested capital" free of excess profits tax a powerful inducement is offered to all business firms to increase in every way possible the amount of "invested capital."

One way to accomplish this is to turn earnings back into the business. If the stock of a corporation is held in most part by men of large incomes — in other words is in strong hands — and if the earnings be distributed in the form of dividends, the amounts so distributed will serve to swell the incomes and hence increase the surtaxes of the wealthy recipients. On the other hand, if the earnings are spent for new buildings or equipment, or in some way retained in the business, a considerable amount is thereby saved to the stockholders to be distributed some time in the future when, it is hoped, surtaxes will be no more. Meanwhile, the "invested capital" swollen by the re-invested earnings furnishes a larger base upon which to figure the 8% exemption.

Causes of Stock Dividends

It is evident that this policy of re-investing earnings must result in increasing the value of the stock. This has two disadvantages. It attracts public attention to large profits, invites public hostility of one kind or another, and by making the price per share unduly large restricts trading and hurts the market for the stock. To remedy the latter difficulty and partially smooth over the former, many very successful industrial companies have split up the shares by the issue of two or three shares for one in the form of a stock dividend. Examples of this are Bethlehem Steel and General Motors. These stock dividends are not taxable since dividing a share of stock into two or a hundred parts adds nothing to the income of the holder. If, however, he elects to sell any of his shares he is taxed upon whatever profit he may have made, if any, upon the proportion of his total holdings which he has sold, regardless of the number of shares into which that proportion has meanwhile been divided.





CHAPTER II

MANAGEMENT AND THE PERSONAL ELEMENT

Character of Enterprise

The management of any business enterprise will depend entirely upon the men who are the real business enterprisers, the men who plan, initiate and carry on the business and assume responsibility. A business like the express, telephone, telegraph or electric service depends to a much smaller degree on the factor of business enterprise than does an industrial enterprise. Any business that is well established, systematized and reduced to a routine can be carried along with a minimum exercise of the elements that go to make up the factor of business enterprise.

Plain honesty is the most important element of management in all business but in these lines it is, with ordinary common sense, almost the only quality necessary. During the constructive period of railroad history, planning, judgment and all the other qualities of business enterprise were highly necessary, but now that the railroad systems have been built, the experiments tried and the service to a large degree standardized the railroad business is tending toward the same degree of standardization that characterizes the express, telegraph or electric service.

Knowledge of Men Important

But in the industrial field the qualities of business enterprise are all-important. Good management has brought success to many a doubtful looking proposition and many of the most promising have been wrecked by poor management. It follows that a knowledge of the men who are the real controlling powers is more important than any other knowledge that can be obtained. Such names as John D. Rockefeller, Judge Gary, Liggett, Woolworth, Kresge, and Whelan, in their respective lines, have stood for much. These men and many others of like ability

have formed the character, intelligence, industry, and much of the ability of the corporations with which they are associated. It is one man or a small group of men that constitute the inmost soul of any industrial corporation. If the speculator can find out who these men are and study their records he has the best guide to the success or failure of the enterprise.

The Calibre Necessary

It is not enough that a man has been successful in the management of a small enterprise. Many a man that could manage one store successfully is lost when he undertakes to manage a chain of stores. A man often succeeds in managing a small enterprise because he can attend personally to all the details. When put in charge of a big business, he tries to follow the same tactics and finds himself swamped under a mass of details and petty discussions, while the big things slip away from him or else his health breaks down in the effort to handle it all.

To be a successful military commander it is not at all necessary that a man be a good grenade thrower, a good gun pointer or an expert with the bayonet. He must be able to grasp a big situation as a whole and keep things in their proper relations. He must be a leader of men, able to pick competent men and delegate responsibility to them, reserving to himself decisions on important matters and the co-ordination of the functions of the officers under him. It is the same in the management of a large industry.

Many men who are successful in one line fail when they undertake to manage a business with which they are not familiar, but first-grade business men do not often make this mistake.

No man is safe to follow unless he is honest. One who is crooked in his business methods sometimes succeeds in getting away with a considerable amount of money for himself, but those who follow him and those who are associated with him in his ventures are almost certain to come out wrong. It is quite possible for any speculator or investor who contemplates the purchase of an industrial security to inquire as to the man or men

who are the real enterprisers, the real managing heads and look up their records.

Many a wise speculator has ridden to success and large profits by hanging to the coat-tails of some man of superior genius. It is easy to see what profits one would make who clung steadfastly to the securities of those companies in which Harriman or Rockefeller were known to be heavily interested. Of course, it is not possible to pick a winner before a man has shown his ability, but there is usually a considerable portion of a man's active life left after he has become a demonstrated success.

Financial Support

Strong men are able to insure financial support to the industries they father. The early years of any business enterprise are always a critical period. This is especially true if the enterprise is started during a period of prosperity. Starting under auspicious circumstances, when business falls off and prices decline, the new firm is very likely to go to the wall unless it has strong financial support. We have already seen this situation develop in many so-called "war babies."

Perhaps the best illustration of strong financial backing and extraordinary management among our new industrial corporations is the American International Corporation. Here is a corporation with almost unlimited fields and possibilities. It was chartered to engage in the import and export trade, to sell American materials and machinery abroad, to furnish American capital and American engineers where needed and to trade in the securities of contributing companies. Fifteen subsidiaries are owned and controlled. Its ownership of stock in the New York Shipbuilding Company, the International Mercantile Marine Company, U. S. Rubber Company and United Fruit Company show its diversity of interest. On its board of directors are Messrs. Vanderlip, Franklin, Kahn, Stone, Ryan, Corey and formerly Judge Lovett and Theo. N. Vail. The company has the backing of the National City Bank. With such banking and management it is difficult to conceive of this company's failing for lack of funds or because of poor management, although it is bound to have its reversals like all others.

CHAPTER III

INDIVIDUAL FACTORS

Dividends Paid

The factors concerned with any individual firm as distinguished from those involving the industry as a whole, are chiefly concerned with the problems of management. The ordinary investor or speculator who is not intimately connected with the affairs of the company has little means of following these matters in detail. For this reason, his best assurance of good management, as we have said before, must come from a knowledge of the business ability, honesty and past records of the men in control.

There are, however, certain broad outlines upon which information is easily available in the case of large corporations whose securities are traded in on the leading exchanges. The statements published by these companies from time to time are useful for purposes of comparison, and if taken over several years will indicate something as to the policies which are being followed.

Many corporations at their inception had no material value whatever behind their common stocks. Such was the case with the U. S. Steel Corporation and the Woolworth stores. These common stocks were originally "all water." But it has been the policy of both companies to put a large proportion of earnings back into the business and thus pile up an equity that gave a steadily increasing value to the common stock. Periods of depression are bound to come, and a company that pays out all its earnings when earnings run high is sure to be in a very poor position when depression comes, sales fall off, and the value of inventories shrinks.

If successive statements show that a company is paying out all it possibly can, that fact may be taken as pretty good evidence that the insiders are unloading the stock and selling out their interests. This is a development that should be watched in new flotations. Almost invariably good-will and sometimes old debts are capitalized, particularly during periods of prosperity. If

large dividends are paid immediately on the common stock issued, money that might prove a valuable asset later will be used up. The purpose of the large dividends many times is to make the stocks look attractive. Such a move is certain to be followed sooner or later by a severe decline in the price of the stock. Furthermore, it may lead to financial difficulties and a receivership in due course of time.

One of the best illustrations is Columbia Graphophone. During the war boom this company increased its common stock outstanding from 150,000 shares to 1,500,000 shares and in October, 1920, it again increased it to 3,000,000 shares.

Dividends paid in the same period increased from \$344,991 in 1916 to \$2,435,402 in 1919.

In February, 1922, the company practically went into receivership.

Value of a Strong Working Capital

To the extent that a business firm lacks a large working capital its position is weakened. Lack of a sufficient fund of ready cash to take up its cash discounts, pay its help, and carry customers who run accounts, makes it depend on the banks for ready money. This is true regardless of the amount or high quality of the fixed assets. While business is good and earnings high, money is also easily obtainable, but in time of stringency, when prices are falling and profits declining, the banks may be unable or unwilling to lend. The greater the firm's need the less willing the banks are likely to be.

Furthermore, a weak financial position puts a company at the mercy of the banks at all times. It then becomes especially important that the men who control the banks should be friendly to the company. The bankers have the opportunity, especially in time of stress, to obtain practical control of the industrial corporation that is in a position of pronounced dependency. Colorado Fuel and Iron would have perished long since except for the fact that powerful bankers were interested and gave support. American Linseed and Corn Products were nursed along for years by strong financial interests until conditions developed that were very favorable to their operation.

The Allis-Chalmers Company was strong in capital assets even when it failed. But business was dull and the great plant did not earn its upkeep. Everyone with common sense knew that sometime demand would develop and the plant would become an earner again, but in the meantime, had the corporation possessed the backing of Standard Oil or the Morgan banking interests the necessary money would doubtless have been forthcoming to carry through.

This causes us again to refer to the fact that it is of the first importance, in judging the present condition or future prospects of any individual concern, to know who owns the stock, and the facts regarding their financial strength and banking connections. The men associated with the management of the American International Corporation cannot prevent a period of business depression from coming in its due course; they, therefore, cannot prevent the International Corporation from seeing comparatively lean years, but they do represent financial interests and financial institutions of great strength and it is quite unlikely that such a corporation would go to the wall for lack of banking support.

Banking Interests Often Friendly

Whenever current liabilities are greater than current assets a company has no working capital at all. It is then completely in the hands of the banks. If these be friendly it may still be carried along. It has sometimes developed that in such a situation the stock may prove to be a good speculative purchase.

If the banks are friendly and the stock very low the big bankers themselves may buy and hold the stock of the corporation on account of the confidence in their ability to build its future. The obviously poor appearance of its statements might even under such conditions have the effect of scaring small or weak holders into selling out, thus bringing liquidations at prices where it is being purchased by strong and friendly interests, who are giving the needed support. This was somewhat the situation in American Linseed in 1914, but such occurrences are rare and such stocks under normal conditions are not attractive.

Reorganized Companies Attractive

The stock of a reorganized corporation is usually a good speculation. In the first place, such reorganization generally comes in times of depression when the prices of all securities are near bottom. Secondly, a reorganization is carried through by men who are strong financially. In fact it is just that fact of financial strength that put them in charge of the company's affairs when the weaker and less competent management broke down.

Nevertheless, it is a fact that many, if not most, speculators avoid such stocks. The fact that the company has failed seems to have greater weight than the fact that new and undoubtedly strong financial interests have entered the management. When we recollect that management is a primary factor in industrial enterprise, particularly when linked up with strong finances, the mistake of looking back rather than into the future is apparent. In reorganization, the old debts are ordinarily wiped out or at least eliminated as a fixed charge, thus reducing the charges ahead of the new stock even though it may be issued in greater amount than the original stock. Furthermore, as the old holders of the indebtedness become stockholders of the new corporation their interests become identical with the interests of all other stockholders.

New Enterprises

From the standpoint of either speculation or investment the securities of new companies are rarely successful. It is necessary that pioneering be done. Those who do it contribute to the world's progress. It is a sad fact that they rarely realize a profit from their ventures. Even in the cases in which new firms are successful we can think of few instances in which the stock could not have been purchased below the subscription price at some subsequent time.

This is especially the case with firms started in times of business prosperity. In a boom period demand for goods is strong, profits are high, and there is every inducement to undertake new enterprises. Yet a little reflection will show that enterprises started at such times must acquire their plants and

purchase their supplies and hire their labor at the prevailing high prices. Even though the management is honest and competent, problems will arise and mistakes will be made. Then in the natural rotation of business cycles, depression will come with falling prices. All these things put a strain on the new enterprise, on top of which it must, to be successful, pay a satisfactory return on a capital investment made when construction costs, labor, and materials were higher.

This has been a prime difficulty in the way of reconstruction of French industrial establishments in the devastated territory. To build factories and equip them at the high prices following the war, doubtless, would have been a charitable act, but it could hardly have proven a profitable investment for those who furnished the money. The ability of such establishments to earn a decent return would depend upon the indefinite continuance of high prices and strong demand. Every economist knew that this was impossible, hence the reluctance on the part of American investors to take hold of the proposition.

Difficulties of Boom Periods

The stocks of new industries started in the time of a boom in any particular line should be particularly avoided. Some years ago there was an epidemic of new rubber companies. Naturally this came on top of the very highest prices for rubber that have ever been seen. More recently a large flock of new automobile companies were started. Some fell by the wayside within a short time. Others have persisted until the present time (1920) when they are being forced out by a falling off in the demand for motor cars and high costs of production.

It is the same with the numerous silver properties that were so widely advertised when silver was above \$1.20 per ounce or more. Few silver mines started on that boom can last with the price well below a dollar.

Besides all this is the fact that fraud plays a disproportionately large part in many such flotations. Poor management, exorbitantly large commissions paid to stock salesmen and retained by promoters, combined with a desire to pay dividends quickly in

order to make the business look attractive, all unite to make the success of these new ventures a very remote possibility indeed. Even though the company should prove one of the rare exceptions that finally succeed there is certain to be a long, lean period in which such stocks can be purchased far below subscription price.

Location of Prime Importance

The location of a manufacturing enterprise, in relation to its markets, freight charges, sources of raw materials and its labor supply, is a matter that is many times not sufficiently considered when business is good. High prices may cover deficiencies in these respects, but when prices slide off and goods are hard to sell keen competition is bound to result. Then an apparently small matter like a disadvantage in freight costs for materials coming in, or finished product going out, may readily assume a fatal importance. With the speculation now going on in our industrial life the factor of location is becoming of prime importance. With declining commodity prices the slight attention that has been paid to this situation in many cases is bound to prove costly.

Ownership of Raw Materials

To own its own sources of raw material is an important asset in times of prosperity or advancing prices. Then the prices of raw materials are high and deliveries poor. The company that owns its own materials can be sure of getting what it wants when it wants it. In dull times or in periods of falling prices, many times it pays better to buy raw materials than to produce them.

In most cases a policy of wise buying based on an understanding of fundamental conditions and business cycles, together with a policy that looks to the maintenance of financial strength, will accomplish all that can be accomplished by producing one's own raw materials, and with much less investment. There are exceptions to this rule. Doubtless the U. S. Steel Corporation could never have grown and expanded as it has without controlling its own sources of raw materials, but this fact will generally be found to hold for the average manufacturing and merchandising concern.

CHAPTER IV

ADVANTAGES AND DISADVANTAGES OF INDUSTRIAL SECURITIES FROM THE STANDPOINT OF THE TRADER OR SPECULATOR

Position of the Speculator

The speculator or trader is not primarily interested in security and income. He buys and sells stocks or commodities for the purpose of making a profit from changes in value. He is engaged, therefore, in discounting the future; he is interested in the financial condition, earnings, etc., of a company, not in order to see if the company is sufficiently solid and reliable for investment, but solely with a view to forming a judgment as to the future trend of the profits.

He will properly buy a stock that has very little present value if he thinks he has reason to believe its value will grow and, as a result, its price rise. If the prospects of a company seem poor, the indebtedness heavy and the earnings falling, these facts would naturally deter the investor from having anything to do with its securities. The very same facts might well recommend the stock to the trader or speculator as a good short-sale.

Greater Risk — Greater Profit

Since the speculator wins or loses then on changes in value, he prefers industrial securities to rails because they fluctuate more. The railroad business has become so standardized and regulated that it is no longer subject to the fluctuations or the manipulations that characterized what we may call the romantic period of railroad history. In the days when the railroads were being constructed and linked up all over the country they occupied much the same position, marketwise, as the great industrial corporations have for the past ten years.

It has not as yet proven practicable to standardize and reduce to routine most manufacturing and merchandising processes, as has been done with the public utility lines. Hence, the industrial lines are still in a dynamic condition. It is in this field that the business enterpriser finds his opportunity to build and expand and improve. In many lines the technical processes are as yet unsettled, changes and improvements in the machinery or processes of production are frequent and sometimes of the greatest importance. In the field of public utilities and railways, public commissions act in one way or another to limit profits, but in the industrial field the opportunities are far wider in spite of the excess profits tax. Hence it is in mainly the industrial field that the progressive, ambitious enterpriser finds the opportunity to create and achieve.

Profit Factors

Three factors are involved in the rise and fall of the values of securities. The technical position of the market is the dominant influence in the day-to-day or week-to-week fluctuations. It is influential above all in determining the time when market movements begin or end, although the real causes of the movement may be much deeper.

By the technical position is meant the financial strength or weakness of the persons in whose hands the title to securities rests. When stocks are held by large, wealthy holders, who control the credit situation through their ownership in banks, the technical position is said to be strong. But the technical position is weak when a large amount of stock is scattered among many holders of moderate means, most of whom own only margins or equities in their holdings and are dependent on the banks for the money to carry them.

The second influence on the price of securities is the money rate. If the current interest rate rises this tends to depreciate the prices of securities, first, because a bond or preferred stock that yields a fixed return becomes less desirable, since the same amount of return can be obtained with less capital than when the

interest rate was lower; secondly, because rising interest rates cut down the profits of all lines of business in which interest is an item of expense in doing business.

Since the returns on bonds and preferred stocks are fixed, and are (unless preferred dividends are not being earned and paid) only remotely dependent on profits, it follows that if one wishes to speculate on this one factor alone he would best confine himself to bonds and preferred stocks.

Fluctuations in Profits

But the great underlying cause for the fluctuations in price of common stocks is fluctuation or rather prospective anticipated fluctuation in profits.

Profits depend on the difference between selling price and costs of production. They are, therefore, increased by anything which tends to widen that spread, and diminished by whatever tends to cause it to shrink. It is well known that when prices rise or fall, the prices of all commodities do not move together. The lines which rise first become very profitable because the rising price of the product is not, at first, offset by rising costs of production. Wages are the chief single element in most production costs and a rise in wages always lags behind a rise in commodity prices. Interest rates too, lag behind prices. Hence a period of rising commodity prices means a period of extraordinary profit for industrial and mining concerns except gold mining.

Railroads and public utilities, on the other hand, having the selling price of their product fixed by public authority, derive little or no benefit from a rise in prices. As the rise in commodity price spreads out into all lines wages must be advanced, because the demand for goods has stimulated production and there is a keen demand for labor in all lines. Also as the laboring class encounter the rising costs of living they gradually come to realize that real wages, as measured in purchasing power rather than merely in dollars, have actually declined and they clamor for an advance to correspond with the rise in living costs.

By the time this situation develops the price rise is nearing

its peak. As prices cease to advance and costs mount, profits are curtailed. Meanwhile common stocks in industrial and mining corporations which represent a right to share in the profits have advanced on the expectation of large profits. But when prices cease to rise and wages and interest continue to mount these expected profits fail to materialize, and a decline in stock prices follows. The next move is pretty sure to be a fall in commodity prices which wipes out profits in many cases and produces a crop of failures. This was the situation that developed with intensity in 1920. And it is upon industrial stocks that the weight of these changing conditions falls most heavily. Hence the wider range of their fluctuations as compared with other securities.

The stocks of railroads and public utilities, the prices of whose products are controlled by law, are affected in a manner nearly opposite. It is only toward the close of a period of advancing prices that public utilities or railroads are allowed to advance their rates. Rising prices mean rising costs for them — rising costs of material and labor. There is some offset in the fact that in a time of industrial prosperity the demand for their products increases and the railroads carry more freight and more passengers and the electric lighting company sells somewhat more electricity. But this offset is not nearly enough to compensate for the rising costs of production. On the other hand when materials and labor fall in price the public utility does not drop its rates until forced to do so. It thus benefits by the conditions which spell adversity to the industrial corporation. This is why People's Gas and Hudson and Manhattan Adjustment Income 5's rose to new high levels in 1921 while industrials, as a rule, did little.

Growth an All-important Factor

The prospect of growth is important from the speculator's position. This includes the prospects for growth of the business in general in which the firm in question is engaged and also the prospects of the particular firm in question. A business that has great future prospects, such as the electrical business, or the

exploitation of corn products, or the self-service stores, makes a more satisfactory purchase from the speculative standpoint than one that has reached or nearly reached the point of saturation and is becoming stabilized.

A corporation is a legal person, but is supposed to differ from a natural person in being exempt from old age and death. But business firms and corporations are not as immortal in fact as in theory. Usually a corporation is started by ambitious men, comparatively young. It has its period of youth, growth and construction. Both the founders and the chief employes grow old, traditions are created which act as obstacles to progress.

Starting with or acquiring early, new methods and new equipment, a corporation that has been in existence a long time is likely to be loaded up with old equipment and old ideas. "Favorite sons" creep in, holding positions and receiving pay that is not justified by their real competitive value. As a result of these various influences there is a tendency toward the same course of life among corporations that we recognize among natural persons; birth—infancy—youth—manhood—mature middle age—ultra-conservative old age, and death. New firms are always crowding to the front supplementing old ones that fail, or are reorganized or incorporated in new ones.

A Virile Organization Necessary

It naturally follows that the common stocks of a young and vigorous corporation, not a new one, are to be preferred to those of one that has—as we may say—turned the corner of middle life. Mortality among human beings is greatest in the early years of infancy, and as a man grows toward maturity he becomes a better insurance risk. The same is true of corporations. The great majority of new promotions fail within two or three years of their inception. Likewise many of the very old and long-established corporations are likely to be poorer risks than one that is younger and more vigorous.

From the speculative standpoint, the firm that has passed through the early years of trial and mistakes, has gotten a firm

grip on life, but is yet young, vigorous and growing, offers by far the best speculative possibility. The analogy may appear fanciful but there is enough truth in it to be useful. The common impression is that the old, long-established firm is the more substantial and the most capable of weathering a storm. Yet that this is not so is nowhere better illustrated than by the recent difficulties of that old stable industrial security — American Sugar Common. To a certain extent this is true as regards the protected investment securities of the firm, but even from the investment standpoint there is a limit beyond which this does not hold.

Furthermore, the speculator must always bear in mind that stocks were made to sell. When a corporation is young and vigorous, when it is growing rather than made, the large owners of the stock are directing a large part if not all their energies to building up the enterprise. When the company is successfully, or apparently, permanently established and good dividends are being paid, the old owners see a good profit on their stock holdings. These large profits available tempt the owners to sell or distribute to the public a large portion of their holdings. It is sad but true — in fact simply human nature — that under such developments the vigor, initiative and strength in the management is apt to decline, with the result that often dry-rot, or as we have termed it — corporate old age — creeps in. This development, it can be readily seen, does not augur well for the large body of scattered stockholders.



CHAPTER V

ADVANTAGES AND DISADVANTAGES OF INDUSTRIAL SECURITIES AS INVESTMENTS

Position of Common Stockholder

The prime requisite for an investment is security. In this respect the securities of industrial corporations differ very widely. Common stock represents the share in an equity, in the profit and risks of a going business after all fixed charges, labor, materials, etc., have been met. If a man buys a controlling share or even a very large proportion of the stock in an industrial corporation he acquires thereby a powerful influence in the conduct of business. That is to say, he engages in business enterprise, and has in that sense invested, yet that use of his money should not be regarded as an investment in the technical sense.

The man is not properly an investor, but a business enterpriser. If, however, he buys only a few shares in a large corporation, whatever his legal or technical rights as stockholder, he has virtually no control whatever over the management of his capital. The commitment is for him a speculation based on his judgment of business conditions in general, and as regards that business in particular, and also on the ability, judgment and honesty of the men who are managing that business. He has no protection against business losses due to failures or mistakes in any of these factors.

Position of Bondholder

If one purchases bonds in industrial corporations, the case is quite different. A bond being a promise to pay a stipulated sum at a definite time with interest is a debt of the corporation and a lien on all its earnings and assets. If the amount of bonds

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and notes outstanding is small in relation to the total capital, if the business has shown stability of earnings over a considerable period of time, if the demand for the products is reasonably certain and the management competent and efficient, such a bond may constitute a high-grade investment.

If the earnings over a ten-year period have been, *in the poorest year*, at least two and a half times the amount necessary to provide for interest and sinking fund on the bonds and the total assets at least twice the total of outstanding bonds this should be sufficient to insure safety.

Stability of Demand and Diversification

A powerful factor contributing toward the stability of an industrial enterprise is that its products be such as are in steady and constant demand. The 5- and 10-cent stores furnish a line of goods that the mass of the people will always buy. Periods of prosperity and depression make comparatively little difference in the earnings. The same is generally true of concerns manufacturing or marketing standard food products or other necessities. At the other extreme are such "feast or famine" industries as the steel business or the manufacture of motor cars. In times of prosperity, the steel business booms and in periods of depression, the earnings may drop very low. The U. S. Steel Corporation has followed a safe and conservative policy by paying out much less than was earned in boom periods and accumulating a strong reserve to maintain dividends when the tide went out. This has served to secure a stability that would otherwise have been lacking.

A corporation that makes a great number of allied products is likely to have a more stable business than one that makes one thing alone. A manufacturing concern that makes only silverware, for example, is at the mercy of conditions affecting the silver market and the demand for silverware. But the earnings of the U. S. Rubber Company are contributed to by every imaginable article of rubber from tires to toys and from rubber clothing to fire-hose.

Character of Demand

Other things being equal, the bonds or stocks of a large corporation with a nation-wide market are safer than those of a smaller, more local enterprise. Prosperity and depression do not affect all parts of the country to the same degree. Business will usually remain good throughout the agricultural regions of the West when New York and New England are in the depths of depression. By the time the depression hits the West the South may still show a fairly good demand, and when that fails business in the Northeastern states is likely to show an improvement. It is, therefore, possible to curtail or suspend production in some of the company's plants and concentrate production or sales in those territories that show the best demand.

Prospects of Growth

It is desirable, but not necessary, from a purely investment standpoint, that the business be one with good prospects of growth. Such was the steel business twenty or even ten years ago. Today, its prospects for further growth are not nearly so good. The economies of large-scale production have been achieved; the uses for steel products have been fully developed, and it is hardly possible that the growth of this industry in the next ten years will begin to compare with that of the past ten. An industrial like Corn Products, on the other hand, has excellent possibilities for growth. The question of growth, however, is far more important from the standpoint of speculation than from the investment angle, and was, therefore, dealt with fully when we considered industrial securities from the speculative point of view.

Preferred Stocks

The revenue laws which allow the money obtained from the sale of preferred stock to be treated as "invested capital" whereas capital represented by bonds cannot be so counted, has given a great impetus to the issue of preferred stocks in circumstances

where, before the war, an industrial corporation would have issued bonds. In form, a preferred stock is just like a common share, except that the prescribed rate of dividend upon the preferred must be paid before any earnings can be distributed to the common stockholders. In the event of liquidation, the preferred shares are ordinarily preferred as to assets.

An investor need not be afraid of the word "stock," provided the same tests are applied to the corporation as to stability of earnings, demand for product, and proportion of preferred stock to total capital that were laid down for testing the security of bonds. In addition, the investor must make sure that either no bonds are outstanding ahead of the preferred stock, or that the quantity of such bonds added to the amount of preferred stock is still within the bounds of safety.

In the case of either bonds or preferred stocks it is necessary to see that no other issues of bonds or preferred stock can be put ahead of the outstanding or proposed issues without the consent of the holders of those securities. In the case of preferred stock, the dividends must be cumulative; otherwise, it will be possible for common stockholders who control the management, to pass all dividends on both common and preferred, putting all earnings back into property, building up equity values that ultimately go to the common stockholders. While the security behind both bonds and preferred stock would be strengthened by such a procedure, the preferred stockholders would be deprived of all return on their money during the process.

Another feature of the present revenue laws (1920) that makes preferred stocks attractive is the exemption from the normal Federal income tax which is granted the dividends on all stocks of domestic corporations. States which, like Massachusetts or Ohio have a State income tax, also grant exemption to the dividends of all corporations of that State which pay income tax to the State. This makes a good Massachusetts or Ohio industrial preferred stock a desirable investment for a citizen of that State since his dividends are exempt from both State income tax and from the normal Federal tax.

CHAPTER VI

THE BALANCE SHEET

Difficulties in Studying

Practically all industrial corporations now issue statements, or balance sheets, to show their financial condition, at least annually.

Every investor who owns or who contemplates buying any industrial securities should certainly take the trouble to look over the annual statements of the corporation in which he is interested. They are equally important for the long-swing speculator. It does little good to look at one statement. A series of statements should be used and a sufficient series to cover normal, subnormal and prosperity conditions. For example, it might do more harm than good, in considering the future prospects of a corporation, simply to study its balance sheet for December 31st, 1918, and 1919. The balance sheet for December 31st, 1920, following a year of deflation, would be quite apt to show a materially different condition.

It is also true that industrial statements sometimes are notable for their lack of information rather than for their wealth of information. Many of them often omit much information that is decidedly important. It is also possible to doctor statements in various ways. Moreover, even the certification of a reputable accountant does not guarantee the appraisal of items in the assets. Neither can it guarantee the accuracy of the firm's calculation as to the amount of depreciation that should be charged off, nor does it ordinarily guarantee the entries in the corporation's books from which the statement is made up.

Holding Companies Particularly Difficult

An industrial holding company, by its very nature, offers many difficulties in analysis. A holding company, controlling

numerous subsidiaries to which, at times, it may lend monetary assistance and from which at all times it receives dividends, can, it may readily be seen, do much juggling between the accounts of the holding corporation and those of the subsidiaries. As a result, in considering the condition of holding companies, a consolidated statement must be demanded, that is, a statement that gives the combined conditions of all the subsidiaries and the parent organization.

If the management of a holding company wishes to make a good showing it is possible to count as income the dividends paid into the treasury from successful subsidiaries and omit the losses of the unsuccessful. In other words, if the parent organization depends for its income on the dividends of the stocks of subsidiaries that it holds, its immediate and direct income would not be affected by losses which prevented the payment of dividends except insofar as the money received from dividends as a whole declined. A holding company can lend money to an unsound subsidiary and count the subsidiary's notes among its own assets. We think there is no point that shows more clearly the necessity of considering the subsidiary statements as well as the statement of the parent organization than this one.

On the other hand, when the subsidiaries of a holding company are making large profits, it is possible of course, for them to declare very small dividends and put the surplus into reserve or plant construction account. Under such conditions, the statement of the holding company, the parent organization, would appear very poor as its income would be small. As a result, owners of the holding company securities would be apt to liquidate their securities, if they simply looked at that condition and did not take into consideration what the subsidiaries were doing in their own organizations.

The Use of Statements

It is, of course, always possible, as we have stated above, for any corporation, holding or operating, to cover up assets or, on the other hand, to waste them. It is difficult to detect a condition

under which items are charged to expense, which should be charged to capital account and as a result, earnings are cut down. It is equally difficult to determine from the balance sheet whether the charges against capital account were conservative or whether a portion should have been charged to expenses. It is, therefore, possible for an industrial corporation to make a statement which reflects the value of its assets to a much less degree than it should, while it is equally possible to render a statement, satisfactory on its face, which gives assets a relatively inflated value.

One might feel, up to this point, that there was little use in considering industrial balance sheets. This is not so. By using a little care and taking a series of from three to four statements, an intelligent idea of the progress or lack of progress of a corporation may be obtained. That is to say, it is possible to tell whether a company is growing stronger or weaker, whether the equity belonging to the stockholders is growing or declining, and whether the business prospects of the company are improving or getting poorer.

The Typical Balance Sheet

The typical statement appears in two-column form—the assets on one side and liabilities on the other. This distinction is easy to grasp if we bear in mind that any item on which the corporation could realize, if it were to liquidate and go out of business tomorrow, is an asset. On the other hand, any item is a liability if it is something that the corporation would have to pay out if it were to liquidate tomorrow. This principle, of course, does not apply to the value of the respective assets or liabilities. For example, if a company were to liquidate, it is quite apparent that some assets would have greater immediate value than others. A manufacturing plant is obviously of more value as a going concern, that is using it to produce goods, than it could possibly be if offered to anyone else. The same is true of goods in process of manufacture that are being made for a definite purpose. It is unnecessary to point out that such assets as trucks, office supplies, patterns, dies, patents, trade marks and good-will have questionable value under liquidation.

The Assets Side

The items ordinarily listed on the assets side of an industrial balance sheet are as follows:

Capital Assets

- Plant and property
- Treasury stock and bonds
- Patents
- Trade marks
- Good-will
- Investments

Current Assets

- Cash
- Inventories (materials and supplies, or stock in trade)
- Goods in process of manufacture
- Accounts receivable
- Accrued interest on accounts receivable
- Drafts and notes receivable
- Accrued interest on drafts and notes receivable
- Accrued interest on bonds owned
- Due from subscribers to capital stock
- Dividends declared on stock owned

Other Assets

- Insurance fund
- Pension fund
- Deferred assets

Sometimes inventories are listed separately as working or trading assets. This is not usual, however. They are placed under current assets, in spite of the fact that their value probably fluctuates more than any other item in the current assets account. Inventories in the last few years, with the inflation and deflation that has prevailed, have fluctuated to an extraordinary degree, first increasing rapidly and then declining.

The Liabilities Side

The items under the head of liabilities are:

Capital Liabilities

- Common stock issued and outstanding
- Preferred stock issued and outstanding
- Bonds issued and outstanding
- Notes issued and outstanding

Current Liabilities

- Taxes accrued
- Payroll accrued
- Expenses accrued (rent, lighting, etc.)
- Notes and drafts payable
- Interest on notes and drafts payable
- Interest accrued on bonds and notes
- Dividends payable

Other Liabilities

- Reserves
- Capital surplus
- Undivided profits

These items appearing on either side of the balance sheet must be supported, in the corporation's income tax report, by schedules showing details which go to make up the various items, but such information is not usually available to the ordinary speculator or investor.

The Individual Items

Assuming that we are in possession of several consecutive balance sheets, let us briefly examine the important items on these balance sheets.

First, plant and property. — Two policies are possible with regard to these items. As we all know, physical equipment

which can be put under this head, with the exception of land, will, in spite of all reasonable upkeep, deteriorate in time. A manufacturing plant deteriorates relatively quickly, at a rate estimated to be at from 10% to 25% a year, depending on the character of the plant. Conservative balance sheets should show this factor, either by constantly writing off a certain percentage of the value year by year, thus giving the plant and property a proportionately lower value, or by carrying the original value in the assets column and setting up a depreciation reserve on the liabilities side. The latter is preferable.

Yet it is quite possible, and has happened many times in the prosperity of the past ten years, that additional plant and equipment have been provided out of earnings. If, under such conditions, the value of the assets is increased, this increase should be accompanied by growth of the item "surplus" on the liabilities side. A gradual reduction in the value given plant and property indicates conservatism and a desire to gradually strengthen the financial position. An adverse factor to be watched is that the value given the plant and property may remain unchanged while the reserve for depreciation is relatively insufficient.

Patents, Trade Marks and Good-will

Patents, while undoubtedly valuable in many cases, have only a limited period to run and are always in danger of infringement, which is hard to prevent. Whatever a firm has paid for its patents must be entered as an asset, but it should always be protected by an especially liberal depreciation reserve on the liabilities side.

Trade marks are valuable only as maintained by steady advertising. Any valuation of them should be low.

Good-will is a real asset in many cases to a going concern, but is usually worth comparatively little in liquidation. If the valuation of this item is large or is increased, it would undoubtedly show that the management was anxious to make a good showing in assets. Such, of course, indicates weakness. The

strongest firms either try to work off this item, or, if maintained on the books in order to give as large a basis as possible for figuring exemption under the excess profits tax, they set up liberal reserves against it, wherever possible.

Investments

A publishing business, or any similar business that accepts payments in advance, must have invested funds to cover the amount of the advance. This is necessary because, in event of liquidation, this money would have to be returned immediately to the payers. Beyond this, however, it is not desirable that a rapidly growing concern, either manufacturing or mercantile, should have a large amount of permanent investments. The best that can be said for them is that they improve the organization's credit. Its business, however, is manufacturing or merchandising, not investing.

Furthermore, unless the items that go to make up this account are available, the value given it may be illusory. Investing is a science. Even the estates of wealthy and successful men show a surprising number of "cats and dogs," worthless investments. These invariably were investments made outside of the lines in which these men were successful. It is naturally apt to be the same with an organization. Hence, as a general rule, a firm does best when it invests its surplus in its own business. Pension reserves or reserves to provide benefits to employes must be invested in outside securities, and these are ordinarily placed in the safest securities obtainable.

Again, permanent investments are only intended to be drawn against in an emergency. In the majority of cases, when the emergency comes, it will be almost certain to fall in a period of liquidation or business depression, or possibly a panic. At such times, even the highest-grade securities cannot be liquidated except at a considerable discount.

Current Assets

Needless to say, a good showing of cash is desirable. A

decrease in this item means that a concern is depending more and more on the banks and is not well trimmed to stand a storm.

Inventories are taken either at cost, or "at cost or market," whichever is lower. This account should be scanned carefully. Over the past few years, many industrial corporations have allowed their inventories to increase tremendously, and it has not been extraordinary to see an organization with an inventory account which equalled or exceeded its fixed assets. If we are in a period of depression and the earnings statement is satisfactory, a large inventory account is often a strong feature. In a period of high prices, the reverse is true.

The large inventory accounts that the majority of industrial organizations showed in their reports for the year ended December 31st, 1919, when prices were approximately the highest we have even known, proved to be a source of very great loss within the next twelve months. Corporations, like individuals, are apt to purchase strongly in an advancing market and to buy most heavily around the top. When an organization can be found which shows a tendency to accumulate inventories in depression years and lighten in years of prosperity, it can be looked upon as being an extraordinarily good risk.

Goods in process of manufacture include labor, materials, inward freight, duties and usually a portion of the overhead. Because these values are real to a going concern, they may be shown in this way. They would, however, bring little in liquidation and they should, as a result, be protected by a good reserve. Conservative firms carry such items as coal, oil, garage supplies, stationery, etc., at a very low value, often nearly nominal.

Accounts Receivable

If a business is one in which it is customary to extend trade credits, like the manufacture of agricultural implements, an increase in notes and drafts receivable may merely indicate a larger volume of sales. At the same time, such a business is exposed to risks that do not exist with the Woolworth stores.

for example. With a business of the ordinary type a marked increase in accounts receivable or notes receivable would ordinarily show that collections are becoming increasingly poor, as the drafts or notes might well be over-due accounts.

Treasury stock should only be counted as an asset when it represents stock that has been issued for value and subsequently repurchased by the treasury.

Fixed Liabilities

On the liability side, the most important items to watch are those which impose fixed charges that cannot be defaulted without incurring foreclosure proceedings. They are, therefore, the bonds and notes outstanding, notes and drafts payable, taxes and payrolls accrued. Dividends, even on cumulative preferred stocks, can be passed or deferred. Stockholders can be told to wait, but bonds and notes must be met when due.

As a result, an increase in bonds and notes outstanding in proportion to the capital stock shows quite clearly that the management is slipping. As a matter of fact, in order to show progressive strength, a decrease in these items should be seen. During the past industrial prosperity it has been valuable to note that certain organizations have been gradually increasing their notes and bonds outstanding, in spite of a tremendous earning power. This probably means that the earnings have been put back into property in the shape of fixed assets. In the meantime, the inventory account has constantly increased, thus necessitating a larger working capital. Inasmuch as a considerable proportion of the earnings have become fixed assets, it has been necessary to borrow additional funds to replenish working capital.

Working Capital

Working capital is the difference between current assets and current liabilities. This is really the all-important item in an industrial balance sheet. It is what makes the mare go. In a consideration of three, four or five consecutive balance sheets,

the relative increase or decrease in working capital should be studied closely. A company may, for example, show a constant increase in surplus, and at the same time, a decline in working capital. Such a condition might develop from numerous sources. As we have pointed out above, increasing the value given to plant and property would be reflected on the liability side in an increase in surplus. Hence, an increase in surplus alone is of little value. An increase or decrease in working capital, however, can only come through an increase in current assets or a decrease in current liabilities, or on the other hand, a decrease in current assets or an increase in current liabilities. Therefore, it is, we believe, the most important factor in the balance sheet, and if a company which is paying dividends shows a decrease in working capital over a number of years, its securities should certainly be avoided.

Current Liabilities

Current liabilities need little explanation outside of that given under the caption of "Working Capital". It goes without saying that taxes, payrolls and expenses accrued should be kept as low as possible. Drafts and notes payable may increase to finance an increase in the inventory account but if they increase without any corresponding increase in current assets, thus decreasing working capital, we can only repeat that it is probably the most dangerous situation that could develop. Interest accrued on notes, bonds and drafts should, of course, be taken care of as soon as possible and should be kept at a low figure.

Capital surplus and undivided profits should show a constant growth. It is always necessary, however, to bear in mind that the surplus account in a balance sheet is the balance between assets and liabilities. It shows simply how much the assets exceed the liabilities. An increase, by itself, is not sufficient to become enthusiastic over. It should be determined whether such increase has come from an increase in current assets, which reflects an increase in working capital, or a marking up of capital or other assets.

CHAPTER VII

THE INCOME ACCOUNT

Points to Get

As with balance sheets, there is little use in considering a single annual income account. A series of at least three or four should be obtained to show the progress, or lack of progress, of the company. In such a comparison, the following, we feel, are the chief points which should be looked into, wherever possible.

First, Net Sales.—This item is not easy to obtain. The primary item in any income account is variously put forward as gross earnings, gross income and gross revenue. Any one of these three factors may comprise income of all kinds from whatever source. What the investor or speculator would like to find is, of course, the revenue obtained from sales of the product that the company is producing. It is for that reason that net sales become important. Gross income often includes interest received on investments, profits from sales of real estate, or in some cases, it has been known to contain merely estimated profits through an advance in the value of real estate or other property held by the company. Furthermore, in times such as we have just been through, the increase in the value of inventories may even be brought into service and appear in the gross income account if it is desired to make a good showing.

Where the item "net sales" does not appear, the entire income account should be scanned carefully in the attempt to determine whether gross income, gross revenues or gross earnings are practically net sales, or whether they include considerable income from outside sources. When other sources of income are negligible, gross revenues will be practically the same as gross sales. Gross sales, in turn, will not differ materially from net sales, if returned goods, allowances and freight charges are very small, which is likely to be the case.

Expenses of Doing Business

Having established as nearly as possible the value of the item in the income account showing the revenue received, our next step is, of course, to obtain, if possible, the cost of selling the goods. Many times, this item is not furnished directly because the company does not wish to give out such information which it feels might be valuable to competitors. In any detailed industrial statement, combining both income account and balance sheet, if we can find the value of the inventory item at the beginning of the year and add to that the factory costs for the year, subtracting from the sum thus obtained inventories at the end of the year, we should have directly the cost of merchandising. Such items are rarely available, however.

The ordinary industrial statement after showing gross income, may simply jump to gross profits from operations. The difference between gross profits from operations and gross earnings is nominally the operating cost. This may or may not include depreciation and renewals according to the wishes of the management. Over a series of years, however, some value can be obtained by comparing constantly the ratio of net profits to gross earnings, although a change in the accounting principles must be watched as it, of course, would throw such deductions askew. Such changes are, however, quite apparent.

Net profits are obtained by deducting administrative and general expenses from gross profits. We again call attention to the value of comparing net profits with gross sales over a series of years, bearing in mind the possible change in accounting principles. Good bookkeeping suggests that income from outside sources, investments, etc., be added in the income account after net profits are determined, but before interest charges are deducted.

A Typical Income Account

We give on next page a typical industrial income account. We have not chosen this illustration for its individual character but rather because it is neither extraordinarily complete nor does it attempt to hide. It can be seen that it follows broadly the

principles laid down previously. It is apparent that total gross earnings as given are obtained from the direct earnings of the company — a steamship corporation:

KERR NAVIGATION CORPORATION

STATEMENT OF PROFITS AND INCOME FOR THE YEAR ENDED DECEMBER 31st, 1918

Gross Earnings of Steamships:		
Freights Earned.....		\$13,237,417.10
Charter Hires		1,602,186.27
		<hr/>
Total Gross Earnings		\$14,839,603.74
Deduct Cost of Operating Steamships including Agency and Brokerage Commissions, Adjustment of Claims, and an Allowance for Depreciation and Accruing Renewals....		
		4,473,912.86
		<hr/>
Gross Profit on Operations.....		\$10,365,690.51
Deduct Administrative and General Expenses.....		170,402.96
		<hr/>
Net Profit on Operations		\$10,195,287.55
Add Miscellaneous Income:		
Interest on Investments.....	\$58,810.26	
Profit on Investments Realized.....	4,048.95	
Interest on Bank Balances	52,575.84	115,435.05
		<hr/>
		\$10,310,722.60
Deduct Interest Charges:		
Interest on Mortgage Notes (All retired as of Dec. 31st, 1918)	\$212,760.00	
Interest on Floating Indebtedness.....	19,093.12	231,853.12
		<hr/>
Net Profits and Income for Year.....		\$10,078,869.48
Deduct Extraordinary Charges:		
Federal Income, War and Excess Profits Taxes for 1917 and 1918 (estimated)	\$4,612,884.54	
Amount Applied in Reduction of First Cost of Steamers in Amortization of War Ex- cess Values.....	4,400,512.50	9,013,397.04
		<hr/>
Surplus Net Profits and Income for Year Carried to Surplus Account.....		\$1,065,472.44
As per certificate of David Elder Co., dated March 21st, 1919, Char- tered Accountants and Auditors.		

In its deductions are included allowances for depreciation and renewals. These might well have been separated so that it would have been possible to see just what had been allowed. Inasmuch as the operating ratio is very low, the natural deduction is that the allowance for depreciation and renewals was not large.

Miscellaneous income is shown clearly and added to net profits on operations. While of little consequence in this instance there is a method of figuring here that is interesting. Net profits and income for the year are given at \$10,000,000 from which are charged the Federal income, war and excess profits taxes for two years, as estimated. This is, from the standpoint of the corporation, the logical place to deduct such a charge, but the investor must remember that income and all other types of taxes are a prior charge on the net earnings of the company and that the actual net profits in this case, although admittedly pulled down by accrued taxes, are roughly \$5,400,000 rather than \$10,000,000.

Effects of Taxation

The effects of the corporation income and excess profits tax law has been very far-reaching. It has offered a powerful inducement to all corporations to make the net profits or net income as small as possible. In the case of smaller corporations, where the administrative officers are also the chief, or perhaps the only stockholders, the tendency is to make salaries and administrative expenses as large as possible. The same pressure shows itself in a policy of ultra-liberal allowances for depreciation, and a tendency to charge what are really — in part at least — capital improvements to repairs and maintenance. The result is to reduce the ratio of net earnings to net sales. This may give the impression that costs of doing business are mounting faster than they really are, and for that reason must be remembered in considering income statements.

Since advertising is considered a deductible expense of doing business under the tax law, sums spent in advertising are not taxed. Therefore, if a corporation finds it is making large profits,

the management is very likely to figure that it is better to spend the money in advertising than to pay it to the government. In other words, the government now pays part of the advertising bill. Advertising will build up good-will and bring future business, yielding revenue for distribution in the happy time when, it is expected, excess profits taxes will be lower or will have gone. In this way, while the ratio of net profits to net sales would be cut down, there would be an invisible asset of good-will growing up.

Whether or not the amount of revenue-producing good-will that is built up by this process will turn out to be worth the enormous sums that are being put into advertising at the present time (1920), even after making due allowance for the proportion of the cost that is saved from taxes, is a question that only the future can answer. The present effect is clearly to lessen the net income.

Difficulties in Judging an Income Account

It is apparent from the above that no hard and fast rule can be laid down in judging income accounts any more than in the case of balance sheets.

There is one general principle which, while it does not meet all the difficulties enumerated, will be found helpful in meeting the more important of them.

If both balance sheets and income accounts be considered in the light of the business cycle, it will be found that as a general rule, there is a strong tendency in times of prosperity, when business is good and profits are plenty, to handle accounts in a very conservative way. The tendency then is to put, not the best, but the worst foot forward, to charge against general expenses what might properly belong to capital account and to build up reserves. The effect is to minimize the showing of assets and earnings. This makes the condition of the corporation look, on the face of it, poorer than it really is. In fact, if this sort of thing is not done, there is reason for suspecting the business ability of the management. It is so widely practised

that the concern not following it will find itself in a very weak condition relatively when the pendulum swings back into the area of depression.

On the other hand, in dull times, when earnings are poor, there is a tendency to make earnings look as large as possible, to charge to capital what really belongs to maintenance, to skimp on repairs, and even to include as income anticipated profits not yet realized.

Effects of Changing Conditions

Another point connected with the course of business cycles, is that toward the end of a period of prosperity, cost of production may be expected to rise. Raw materials are high and wages have advanced. Furthermore, labor becomes less efficient at such times. This is partly because the competition for jobs among laborers has given way to a competition among employers for help, and under such conditions discipline is difficult, labor-turnover increases and the laborers are careless and disinclined to sustained effort. Another reason for the inefficiency of labor at such times is that the demand for labor takes into employment the less efficient class of laborers who in dull times find it difficult to obtain employment at all. It is natural, therefore, for the margin of profit to decline even though gross sales continue large.

When demand falls and help is laid off, these employees are the first to go. The result is an increase in the average efficiency, which is still further raised by the fact that those who still retain employment are more anxious to please lest they too be laid off. Therefore, while demand is less the margin of profit will increase.

Interest rates also rise toward the end of a business boom. Fewer customers take up their cash discounts and hence more capital is needed just when more is hard to get. This shows the importance of drawing in during the height of a period of prosperity, setting up liberal reserves, strengthening working capital and building up otherwise, even though it may be at the expense of net profits for the time being.

CHAPTER VIII

ANALYZING CONSECUTIVE BALANCE SHEETS

Use of a Concrete Example

To assist the reader in making a concrete application of the principles that should be followed in comparing the consecutive balance sheets of a business enterprise the statements shown herewith are submitted. The corporation used is engaged in a metal stamping business. The actual figures have been altered to show amounts to the nearest \$100.

Let us examine the initial balance sheet, 1913. These are two points which should attract the attention of any observer even without any inside knowledge of the business. The first and most striking is the large size of the item — all debts — as compared with the net quick assets as shown by the items cash, plus notes and accounts receivable. In round figures the company owed on notes and accounts payable \$536,000 against net quick assets of only \$238,000.

Evidently at that time the company was at the mercy of its creditors if pressed for payment. The item Merchandise, Raw Material and Goods in Process, while large, does not help the situation very much because it is obvious that these assets could not be turned into cash quickly without taking severe losses, at forced sale. Even taking this item at its face value gives only \$668,000 against a debt of \$536,000 — a narrow margin at best. Apparently the company was doing business on a floating debt in place of a supply of working capital.

A Poor Situation

A second point bears this out. A comparison of the item Merchandise, Raw Material, and Goods in Process (\$430,000) with the item Net Sales for the year (\$934,000) shows that, either

the company had a large amount of unsold goods on hand, or else was very heavily loaded up with raw materials.

The first interpretation would indicate poor selling, the second, that the company had tied itself up with raw material which it did not have the money to pay for. It further was out of any reasonable proportion to current requirements since the total sales for the whole year were little more than double this amount. With no information other than that furnished by this statement such a situation is *prima facie* evidence of poor management.

Some Important Changes

The balance sheet for December 31st, 1914, shows several important changes. The company is getting along on less than half the cash—evidently as much as possible has been used to pay debts.

The increase in Notes Receivable shows that some long-standing accounts had been turned into notes—a good move. This might partially explain the reduction in the item Accounts Receivable. The rest is easily accounted for by the falling off in Net Sales. The item Accounts Receivable is still large for the amount of sales, altho without further knowledge of the nature of the business and the trade customs therein we could draw no positive conclusion on this point.

The reduction in the item General Supplies and Fuel shows that either this item had been over-valued in the previous statement or else a pronounced economy had been effected in this regard—a good indication in either case. The reduction in the item Advertising looks like better management.

Reduction in Debt Marked

The most important improvement is the reduction in the debt to \$297,000 from \$536,000, a reduction of \$239,000. We naturally want to know how this was done. The explanation is found in the following facts:

Evidently since the capital stock has been increased by \$132,000, the creditors have been induced to take stock to this

amount in settlement of their obligations. Notes must be paid when due, interest and principal, or bankruptcy ensues, but stock has no such claim. Stockholders can wait for dividends until they are earned.

The reduction in cash would seem to show that \$16,000 of the debts had been settled with cash on hand.

The reduction of the item Land and Buildings from \$126,000 to \$84,000 might indicate that the company had sold property to that extent. If so, the money has been used to pay debts to the extent of \$42,000 and the position of the company thereby strengthened. If it can be ascertained that no real estate has been sold during the year then the valuation of Land and Buildings has simply been reduced. If a corresponding reduction in the debt has been made out of earnings it is an even more favorable development for that much padding has been taken out of the assets and under-valued assets indicate strength.

Turning Goods into Money

The reduction of \$87,000 in merchandise, etc., would seem to indicate that a portion of the unsold goods on hand had been worked off—presumably at a loss, or else that some of the surplus raw material had been used up. This is especially desirable in view of the falling off in net sales of \$175,000. In fact, a failure to reduce inventories in the face of diminishing sales would look very bad.

The rest of the apparent shrinkage in assets is taken up on the liabilities side by a bold writing down of the surplus from \$107,000 to \$18,000. Values of assets have evidently been courageously deflated.

A Further Strengthening

The next year (1915) shows a gain in working capital represented by cash assets and accounts receivable in spite of a shrinkage in net sales. An important reduction in the inventory item (Merchandise, etc.) shows further economy in operation and a

jettisoning of some more of the overload that contributed to make the ship top-heavy in 1913.

The decrease in the item, Machinery and Dies, shows an economy that should appear in view of the smaller volume of business. The fact that this was not done the year before in the face of smaller sales is the only weak spot in the comparison of the balance sheets of 1913 and 1914.

The statement for 1915 shows nearly \$90,000 more scaled off the debts with no reduction in surplus. This progressive reduction makes it evident that earnings are being applied to paying off the sort of obligations that threatened to put the company into bankruptcy in 1913.

The 1916 Year

The points of interest in the balance sheet for 1916 are: A reduction in Notes Receivable, showing good collections. The increase in Accounts Receivable is justified by the increase in Net Sales, as is also the increase in inventories.

Machinery and Dies have been written down. Since a larger business was done than in 1915 it is evident that the producing power of the plant was not injured by the reduction in machinery and dies. This creates the probability that the actual amount of useful machinery and dies has not really been reduced at all, but that the valuation of these items has been scaled down to allow for depreciation or obsolescence.

The debt continues to fall and the surplus shows a substantial increase.

The disappearance of the item Advertising, in view of increased business, requires comment. If the firm really stopped advertising it is not likely that its business would increase. So we must infer that advertising matter on hand had been kept down by good management or was simply ignored in making up the statement. This would be very conservative since such matter is worth nothing if the firm were to liquidate, and hence had better be charged to expenses and then forgotten if possible.

A Very Strong Position

Furniture and fixtures have apparently been written down in value since it is wholly unlikely that the company is doing a larger business on less than one-eighth the office furniture than it had in 1913. The item has probably been reduced to a "red-flag" (*i.e.* auction room) valuation, even though some may have been dispensed with. Good economy in any case.

The same trend is seen when we turn to the 1917 report. The reduction in Accounts Receivable shows improving collections and makes it look as though the firm was shortening its credit lines. Increasing inventories in face of less sales does not look so good. But the further large reduction in debt shows that the company could afford to invest in material if it wished.

The operation of the war revenue laws shows in the creation of reserves for taxes and dividends, largely at the expense of surplus.

The Transition Completed

The remaining years require but little comment. The debts continue to fall and the cash to rise. In considering the items for the years 1916 and following, it must be remembered that prices were rising and larger figures for Inventories, Accounts Receivable, and Net Sales should be expected and do not necessarily indicate a larger volume of business as measured in physical units. Because the number of dollars' worth of business was increased greatly many business men have fooled themselves into believing that they are doing more business when, in fact, they are selling perhaps fewer physical units of goods but getting a higher price. The increased profits in dollars must be discounted the same way, remembering that a profit of \$100,000 in a year in 1914 was really bigger and would buy more than \$175,000 in 1918 or 1919.

The above example is offered because it shows the transition under able management from a position of financial weakness to

one of growing strength. This is the sort of progress that should be looked for in comparing balance sheets, as it is practically impossible to fix up balance sheets, over a series of years so as to show such a trend unless the real condition is improving.



TEST QUESTIONS
ON
"INDUSTRIAL SECURITIES"

These TEST QUESTIONS can be answered directly from the TEXT discussion. You will find them helpful for purposes of review.

1. Why are industrial securities so attractive to the speculator?
2. What is the biggest factor in successful industrial enterprise?
3. What general factors should be studied before buying an industrial?
4. What individual factors?
5. What are the principal points to look for in an industrial investment?
6. Why can little weight be given the surplus account?
7. What is working capital? What does declining working capital indicate?
8. What are the vital points to seize upon in an income account?
9. How should income accounts be judged?
10. Explain in Balance Sheets on page 48 why cash declined in 1919 and accounts receivable increased.

ANALYSIS OUTLINE FOR INDUSTRIAL SECURITIES

This Analysis Outline is given you to enable you to judge the soundness and progress of an industrial enterprise. The factors should be answered to your satisfaction under the principles set forth in the text.

A. The Enterprise

1. Type
2. Location
3. Product
 - (a) Fluctuation in Demand
 - (b) Diversification
4. Source of Raw Materials
5. Competition

B. The Personal Element

1. Financial Control
2. Financial Backing
3. Relations with the Banks
4. Directors
5. Financial Policy

C. The Income Account

1. Study a Series
2. Gross Sales
3. Gross and Net Profits
4. Outside Income
5. Interest Charges
6. Reserves
7. Charge for Depreciation

D. The Balance Sheet

1. A Series Necessary
2. Working Capital
 - (a) Its Size
 - (b) Its Growth
3. Fixed Assets
 - (a) How Valued?
 - (b) Relation to Working Capital
4. Treasury Investment
 - (a) Size
 - (b) Soundness
5. Patents, Etc., Overvalued
6. Current Liabilities
 - (a) Relation to Fixed
 - (b) Growth
7. Reserves
 - (a) Liberal
 - (b) How Invested?
8. Surplus

Earned, or Has Plant Been Marked Up?

BALANCE SHEETS — YEARS ENDING JUNE 30

ASSETS	1918	1919	1920	1921	1922
Land, Machinery, etc.	\$20,225,567	\$21,287,960	\$22,970,292	\$26,276,482	\$31,596,307
Other Property	25,883,704	25,899,322	26,264,242	26,807,090	23,539,146
Sinking Fund	1,998	1,035	14,239	6,812	17,022
Bond Discount, etc.	1,307,229	2,351,687	3,784,773	6,430,357	4,435,193
Unexpired Insurance, etc.	318,204	379,346	387,179	336,173	301,414
Accounts Receivable	20,703,384	26,168,067	29,440,465	25,447,500	18,880,295
Inventories	19,523,208	19,514,430	17,178,292	18,339,871	13,318,304
Cash	2,784,987	2,526,184	3,375,099	4,134,120	2,498,517
Notes and Bills Receivable	12,056,986	12,605,544	11,330,178	18,099,784	19,190,738
Total Assets	\$102,305,267	\$110,733,575	\$114,744,759	\$125,878,189	\$113,776,936
LIABILITIES					
Common Stock	\$18,430,900	\$31,655,200	\$31,979,400	\$33,322,126	\$33,322,126
Preferred Stock	27,648,200	28,381,200	28,455,200	28,455,200	28,455,200
First Refunding Mortgage Bonds				30,000,000	30,000,000
First Mortgage Bonds	8,252,000	7,443,000	7,015,000	6,616,000	6,247,000
Debenture Bonds	9,100,000	5,360,100	5,035,900		
Reserves	2,048,376	2,833,381	3,287,004	7,046,658	7,130,790
Accounts Payable	3,118,232	2,855,011	2,794,347	1,226,056	1,253,998
Notes Payable	17,020,000	14,917,500	17,880,000	15,522,000	4,806,356
Accrued Interest	292,733	204,706	192,602	1,020,200	1,015,588
Surplus	16,394,829	17,080,477	18,105,306	2,669,949	1,545,878
Total Liabilities	\$102,305,267	\$110,733,575	\$114,744,759	\$125,878,189	\$113,776,936

KEY PROBLEM FOR INDUSTRIAL SECURITIES

Note the Balance Sheets on opposite page. They are for one of the leading Industrial Corporations of the country. Analyze in the light of what you have learned in the last chapters of this Text.

1. Has the position of the company improved in five years? If so, how?
2. Do you consider its working capital at the end of the period strong or weak?
3. What is the relation of Inventory to total current assets? Of Bills Receivable?
4. Note changes in capital structure. What have they done?
5. How has working capital been built up?
6. Is that method good business?
7. What made the surplus decline so rapidly?

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